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DIRECTORATE OF INTELLIGENCE

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China's New Enterprise Law: Management Reform Half-Step

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SUMMARY

The state enterprise law, which China's upcoming National People's Congress will probably approve, is a further step in clarifying factory director responsibilities and in holding state-owned enterprises responsible for deficits. Once the law is enacted, Beijing probably will pressure localities to close some failing enterprises to demonstrate that state-owned firms are not immune to bankruptcy. However, the draft law is riddled with ambiguities, and we believe most factory managers will continue to place worker, party, and bureaucratic interests ahead of profit and efficiency in order to maintain shopfloor harmony. For its part, Beijing will have to weigh the risk of triggering worker unrest in deciding whether to close unprofitable firms.

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What the Enterprise Law Will Do

Passage of the state enterprise law, which we expect to occur at the National People's Congress (NPC) later this month, will be a policy milestone in China's efforts to professionalize enterprise management and to hold enterprises responsible for deficits. Passage had been held up for years by resistance from conservatives and debates over worker welfare and the role of factory party officials in management decisions. But sustained poor performance among state-owned firms--the core of China's industrial sector¹--helped reformers overcome opposition and gain preliminary approval for the draft law by the NPC's Standing Committee and the State Council. [REDACTED]

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The draft law, which Beijing released in January:

- Affirms the status of state-owned enterprises as legal entities.
- Identifies the manager as the legal representative of the enterprise and specifies some of his responsibilities.
- Lists powers assigned to enterprises, including the right to set prices, market their products, undertake investments, and issue bonds, subject to other regulations and the state plan.
- Declares that enterprises can reject guidance from government departments, except for production tasks assigned by mandatory plans.
- Assigns local Industrial Commercial Bureaus the task of arbitrating disputes between enterprises and their supervisory government departments.

The law thus provides a basis for broad reforms for state-owned firms. Indeed, it is one of several complementary enterprise reforms, including the contract management responsibility system,² the reorganization of the bureaus that supervise enterprises into for-profit corporations, and experiments with stock sales and mergers. In addition, Chinese officials have told the US Embassy in Beijing that the State Council has approved "in principle" a plan to revise the tax system that would further weaken the links between enterprises and local bureaucrats. [REDACTED]

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¹ Roughly one-fifth of China's half-million industrial enterprises are state-owned, but they produce almost 70 percent of the nation's industrial output, and include virtually all heavy industrial firms. State-owned firms have registered the slowest growth in profits and tax remittances of all Chinese businesses, and roughly one-fifth are in the red, according to Chinese figures. [REDACTED]

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Limitations Remain

Ambiguous language nonetheless will weaken the effectiveness of the enterprise law. Also, virtually every power and responsibility spelled out for enterprises and managers is subject to other regulations and plans. Such contingency clauses will make for wide variation in interpretation. For example, although the draft law allows enterprises to set prices for their products, they will still be subject to extensive price control regulations. Indeed, unauthorized price hikes by state enterprises are a major target of Beijing's current anti-inflation drive. []

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The draft law perpetuates ambiguities in the relationships among managers, enterprise party officials, and worker organizations. For example, it sidesteps the longstanding controversy about the legal status and powers of factory party committees with a compromise "statement of principle" assigning party organizations responsibility for ensuring that the enterprises "implement all party and state policies." While some party officials had lobbied for more explicit definitions of party functions, this statement gives them carte blanche authority to question every important aspect of factory operations. []

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Worker organizations, in contrast, are assigned specific powers in the draft law. The manager must submit wage, bonus, and welfare plans, along with "major rules and regulations," to workers' congresses for approval, and most other management decisions are open to discussion by worker representatives. For example, worker organizations can evaluate the performance of all administrators, can even recommend they be dismissed, and can vote on the selection of the factory director himself. Although Chinese worker organizations lack the independence of Western labor unions, the law, by granting workers a say in enterprise operations, will probably reinforce the tendency of managers to place worker welfare demands and shopfloor harmony above plant efficiency and profitability. []

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Finally, government administrative bureaus will still have a say in enterprise operations--they will impose plan targets, control relations between the enterprise and outside units, and appoint and dismiss factory directors. Given these stipulations, we believe the draft law makes only modest progress in freeing the enterprise from government meddling. []

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What's Ahead

Chinese media have candidly reported objections to the draft enterprise law, and some revisions have already been made. On one hand, managers have attacked vague definitions of their powers, while a signed commentary in Worker's Daily complained that the law does not clearly stipulate that the workers are "masters" of the enterprises. And an obliquely worded article in the World Economic Herald suggested that more reform-minded economists fear the law will solidify enterprise reforms at the current half-planned, half-reformed stage, and thus will impede liberalizations such as enterprise

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ownership reforms. Although these articles probably presage the themes of debate that will be voiced at the upcoming NPC, we believe Beijing has invested too much in publicizing the law to allow it to falter; the party Politburo has even endorsed the draft.

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Passage of the law will activate the trial bankruptcy law that has been on the books for more than a year (see inset). Some reformers want to use the threat of bankruptcy to force managers to emphasize profitability and efficiency, even at the expense of some worker benefits. Effective bankruptcy legislation could also help China's banks recover defaulted loans, boosting the effectiveness of the banking system in controlling unwarranted capital construction outlays.

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Paving the Way for Bankruptcy

Although bankruptcy has become a fact of life for China's proliferating small businesses--the Minister of Agriculture has told US Embassy officials that roughly 10 percent of town and township enterprises are going under every year--state enterprises have been virtually immune. But bankruptcy proceedings against state enterprises can begin three months after the NPC approves the state enterprise law, under the provisions of a December 1986 trial bankruptcy law passed by the NPC Standing Committee.

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Understandably, moves to invoke bankruptcy will be resisted. Managers and local officials will argue that they cannot be held accountable for conditions beyond their control--such as irrational prices and scarce materials--that contribute to losses. Furthermore, real progress in trimming bloated work forces to cut costs or in closing deficit-ridden enterprises risks triggering widespread worker unrest.

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We believe these concerns will probably lead Beijing to go slowly on bankruptcies--closing only a few test case enterprises initially and bending over backward to ensure that the workers find new jobs. Recent cases of successful enterprises' buying out money-losing firms may provide localities a less divisive alternative to outright bankruptcy.

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In addition to activating the bankruptcy law, the passage of the enterprise law may set the stage for Beijing to press ahead with even more controversial measures, such as price and tax reforms and even the removal of party committees from enterprises altogether. We nonetheless expect Beijing to move cautiously out of concern that disruptive change could spark resistance or urban unrest that would jeopardize the entire enterprise reform movement. If Beijing fails to carry through with the threat of bankruptcy or with other reforms, however, we believe the ambiguities of the enterprise law will limit its impact on the performance of state-owned enterprises.

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